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Practice Group(s):
Real Estate

Can Heads of Agreement That Are "Subject to Contract" Still Bind You?

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Background

It is common practice for parties to property and business transactions (such as sales, purchases and leases) to sign a heads of agreement once an agreement has been reached in relation to the key commercial terms of the transaction, but prior to the preparation and entry into a formal contract. Difficulties can occur when the parties only intend that a binding agreement arise upon entry into the formal contract, but the heads of agreement in fact constitutes a binding agreement.

Recent Case

In *Confidential and Commissioner of Taxation [2013] AATA 76*, the vendor's agent had prepared a heads of agreement for the sale of a business based on a *pro forma* heads of agreement. The vendor and purchaser signed the heads of agreement prior to obtaining legal advice. The agent did not intend that the heads of agreement bind the parties other than in respect of exclusivity and confidentiality, and understood that a formal contract would be required if the parties intended to proceed with the transaction.

The Administrative Appeals Tribunal of Australia (Tribunal) considered that the relevant question was whether the heads of agreement operated as a legally binding document between the parties. It was determined that the agent's intentions in relation to the effect of the heads of agreement, and the subjective intention of the parties, were irrelevant.

Despite containing an express provision that the heads of agreement were "subject to and conditional upon" (among other things) the vendor and purchaser entering into a formal contract for sale to be prepared by the agent, the Tribunal found that the heads of agreement:

- clearly indicated that the parties had agreed to the sale of the business
- contained the essential terms of the sale of the business
- expressly stated that the parties intended to be bound by the heads of agreement
- operated as a binding legal document in respect of the sale of the business and not just in respect of exclusivity and confidentiality.

The Tribunal's finding had a significant adverse impact on the vendor's taxation position.

"Subject to Contract" Clause

In this matter, the Tribunal found that the inclusion of a "subject to contract" clause in the heads of agreement did not negate a binding agreement arising before the parties entered into a formal contract because:

- there can be an informal binding agreement with the expectation that other terms will be negotiated and agreed, and by consent included in a formal contract

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- the formal contract was simply intended to restate the terms set out in the heads of agreement in a fuller and more precise form but not different in effect, and the parties had intended to substitute the formal contract for the heads of agreement.

The heads of agreement fell within the well-established legal categories of agreements that, although being stated to be "subject to contract", were nevertheless binding.

Lessons

- Heads of agreement should clearly state whether they are intended to be binding on the parties.
- There are traps in using *pro forma* documents and it is always prudent to have such agreements legally reviewed before signing them.
- If the intent of the parties is to provide a prospective purchaser with a due diligence exclusivity period, then it might be sufficient to simply document that arrangement by a confidentiality agreement.

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